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July 28, 2004

***BY HAND***

Mary L. Cottrell, Secretary
Department of Telecommunications and Energy
One South Station, 2nd Floor
Boston, MA 02110

RE: Petition of NSTAR Gas for Approval of Changes in its Gas Procurement Practices, D.T.E. 04-63

Dear Secretary Cottrell:

On June 18, 2004, NSTAR Gas Company ("NSTAR" or the "Company") filed with the Department of Telecommunications and Energy ("Department" or "DTE") a three-page letter and a PowerPoint presentation requesting authorization to change NSTAR's natural gas purchasing practices (the "NSTAR Letter"). NSTAR asserts that the proposed modifications to its gas purchasing practices would mitigate the effects of price volatility for its customers. On July 7, 2004, the Department issued a Notice of NSTAR's proposal that set July 28, 2004 as the deadline for submitting comments on the Company's filing. Direct Energy Marketing, Inc. ("Direct Energy") is pleased to provide the following comments.

*1. To the Extent that NSTAR's Proposal Involves Financial Derivative Products, The Department Should Require NSTAR to Provide Further Information Regarding Its Plan and Demonstrate That The Plan Complies with the Department's Standards Set Forth In Risk-Management to Mitigate Natural Gas Price Volatility, D.T.E. 01-100 (2002) ("Risk-Management")*

In *KeySpan Energy Delivery New England*, D.T.E., 03-85 (2003) (*KeySpan*), the Department approved a KeySpan proposal that NSTAR asserts is similar to its proposed plan. *See* NSTAR Letter at 1. In approving the KeySpan proposal, the Department noted the distinction between the timing of gas purchases to manage risk and the use of financial derivative products. *KeySpan* at 4 n.1. The Department described KeySpan's proposal as one only involving the timing of gas purchases and not involving the use of financial derivatives. *KeySpan* at 5.[1] Indeed, the Department specifically stated that "[i]n the event that [KeySpan]

[1] In its October 14, 2003 Reply Comments in *KeySpan*, KeySpan asserted that its proposal involved programmatic purchases over time that were not tied to particular index prices or index performance. KeySpan Reply Comments at 5. KeySpan explained that it would administer the program by altering its gas purchasing schedule to allow for 12

intends to use financial derivatives, [it] must seek Department approval prior to entering into this type of transaction." *Id.* at 5 n. 2. This distinction is important because the use of financial derivative products involve additional costs which must be recovered from customers. In *KeySpan*, the Department found that there were no implementation costs to recover under KeySpan's proposal, and thus, there was no danger of misallocation of costs or any affect on the reliability and transparency of rates charged by KeySpan. *Id.* at 5.

It is unclear whether the same can be said of NSTAR's proposal. In the NSTAR Letter, NSTAR proposes to "purchase 1/12 of the supplies necessary to guarantee price certainty on volumes approximately 1/3 of the projected normal winter requirement in each month of the twelve-month period beginning November 1, 2004 and ending October 21, 2005." NSTAR Letter at 2. NSTAR goes on to state that because the Company would not be taking physical delivery of the gas when the monthly purchase is made, the Company "must accomplish these purchases through financial contracts that would lock-in the prices for designated volumes." NSTAR Letter at 2. Specifically, NSTAR states that it will:

> enter into financial arrangements with large financial institutions, wherein the Company would agree to pay a fixed price for a fixed volume of gas at a point in the future. The fixed price would be based on the NYMEX futures prices for each month of the coming heating system at the time the agreement is entered into. Under the agreement, the difference between the fixed price of gas and the actual market price of gas at the time of purchase would be reconciled between the Company and the financial institution.

*Id.*

While it is not clear from the two companies' filings, it appears that unlike KeySpan, NSTAR may be proposing to use financial derivative products. If this is the case, Direct Energy is hard pressed to understand how NSTAR's proposal could not involve implementation costs which will be passed on to customers. To enter into a financial arrangement with NSTAR, the financial institutions must be receiving some benefit and that benefit would constitute an additional cost to NSTAR customers. In its letter, NSTAR does not clearly assert, as KeySpan did in its Reply Comments in *KeySpan*, that "[t]here are no costs associated with implementing [its] program aside from the commodity price of the gas. . . ." KeySpan's Reply Comments at 5. Instead, NSTAR states that the Company will not incur "transactional costs in excess of the available locked-in price based on NYMEX future prices." NSTAR Letter at 2.

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equal purchasing increments and that it would be purchasing gas based on NYMEX prices available in each month over a 12-month period. *Id.* at 6.

Direct Energy believes that the Department needs further information from NSTAR to determine how the NSTAR plan differs from the plan the Department approved in *KeySpan*. If NSTAR's plan does involve derivative products, the Department should require NSTAR to disclose the costs involved and explain why all of its customers are required to participate in the plan and why all the costs associated therewith are allocated to all customers. *See Risk Management* at 15-16 and 28. Moreover, NSTAR should be required to present its proposal for cost recovery as well as accurate and timely price information. *Risk Management* at 16.[2] Finally, the Department should require NSTAR to demonstrate what effect the plan would have on the reliability and transparency of commodity prices. *Risk Management* at 28.

2. *The Department Should Reconsider Its Risk-Management Approach and Allow the Competitive Market to Offer Products and Services Which Address Volatility Concerns.*

Regardless of what the Department determines regarding NSTAR's use of derivative products, however, Direct Energy respectfully requests that the Department reconsider its overall approach regarding the sale of risk-management products and services. As the Department noted in *KeySpan*, the Department addressed the appropriateness of using risk-management techniques to mitigate natural gas price volatility in *Risk-Management*. Because Direct Energy only recently began exploring the possibility of entering the Massachusetts natural gas market, it did not participate in either *Risk Management* or *KeySpan*. It also notes that no competitive suppliers provided comments in *KeySpan*. Thus, Direct Energy would like to take this opportunity to (1) outline for the Department its view that the use of risk-management techniques by LDCs impede the development of retail competition in Massachusetts; and (2) respectfully request that the Department reconsider its approach and allow the competitive market to offer products and services which address volatility concerns.

a. <u>The Department's Standard</u>

The Department addressed the appropriateness of using risk-management techniques to mitigate natural gas price volatility in *Risk-Management*. A key issue in that proceeding was whether risk-management programs by LDCs would affect gas unbundling and customer choice

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[2] For instance, NSTAR should explain whether it intends to set up its own NYMEX exchange trading account or if it intends to pursue such transactions through third parties. If it intends to directly participate in exchange trades, it will be subject to NYMEX margin requirements, which are not insignificant. For instance, if its portfolio reaches 1,500 futures contracts (equivalent to 15 BCF), the margin requirements could be several million dollars.

If NSTAR intends to pursue transactions such as NYMEX swaps or triggers, the margin requirement costs will be incurred by a third party. These costs, however, will be built into the prices charged by the third party for the swap or trigger. NSTAR should explain to the Department how it intends to recover these costs. In addition, it should outline for the Department its plan for addressing third party creditworthiness.

in Massachusetts. *Risk-Management* at 2. In its decision, the Department emphasized the importance of the goal of promoting gas unbundling and customer choice, finding that "it is important that the Department consider the likely effect of any financial risk-management program on the development of a competitive retail market in Massachusetts before it approves such programs." *Id.* at 14. The Department concluded that financial risk-management programs would not adversely affect gas unbundling and customer choice if such programs (1) provide all customers with an opportunity to obtain more stable prices and allocate costs only to those who participate in the program; and (2) ensure efficient competition among all suppliers involved in the merchant business. *Id.* at 16-17. In *Risk-Management*, the Department ordered LDCs to present any risk-management plan to the Department for approval before implementation. In making such presentation, the Department directed LDCs to demonstrate, among other matters, that their risk-management plans ensure fair competition in the gas supply market. *Id.* at 28.

In *KeySpan*, the Department considered for the first time a LDC's risk management proposal. Regarding the proposal's affect on competition, the Department concluded that because KeySpan's plan would benefit all customers at no additional costs, there would be no negative affect on reliability and transparency of rates and therefore, the proposal would not impede fair competition in the gas supply market. *KeySpan* at 5.

b. *Allowing LDCs To Offer Products and Services Designed to Reduce Price-Volatility Impedes Competition in the Retail Natural Gas Market.*

Since ordering statewide implementation of retail natural gas competition, Massachusetts has made significant progress in implementing customer choice. Among other matters, the Department has ordered the unbundling of customer bills, the licensing of competitive suppliers and education programs designed to encourage comparative shopping. Due to these efforts, today, large numbers of industrial and large commercial customers are being served by competitive suppliers. Residential customer participation in the natural gas market, however, is such that almost all residential customers still receive their natural gas supply service from the LDCs.

It is Direct Energy's view that in order to sustain the progress made in the industrial and large commercial segments and move forward to create a robust market for residential and small business customers, the Department must seek comprehensive solutions to the barriers to competition in the mass markets. Direct Energy believes that having the LDCs introduce new gas supply products at this time is a barrier to competition which deters new entrants from entering the market.

Instead, products and services designed to smooth out price movements should be provided by the competitive market.[3] In its comments in*Risk-Management*, NSTAR described how LDCs providing such products and services would negatively affect gas unbundling and customer choice in Massachusetts:

> [C]ompetitive suppliers often attract customers by offering products and services that the LDC does not, which would include fixed-price options and other gas-cost management services. If LDCs implement comprehensive measures to lessen or eliminate price-volatility or to offer products and services that can be offered by competitive suppliers, it will make it more difficult for competitive marketers to distinguish their prices and products from those of the LDC, which may impede the development of retail competition in Massachusetts.
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> NSTAR Comments, *Risk-Management* at 9.

The competitive market is the appropriate vehicle for these products and services because not only does the competitive market have the expertise to market and price these types of products, it is experienced in analyzing and trading derivative products. As NSTAR concluded in its Comments in *Risk-Management:*

> the use of [risk-management tools] generally requires a high level of market expertise, the ability to gather, compile and analyze market data, and superior forecasting techniques . . . . For those reasons, the use of hedging instruments is best undertaken by competitive market participants who have experience with national markets and specialize in the use of these mechanisms.
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> NSTAR Comments, *Risk-Management* at 8.

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3 As stated above, competition has yet to reach the Massachusetts residential market. In its answers to the Department's information requests in *Assignment of Interstate Pipeline Capacity*, D.T.E. 04-01 (DE-8), Direct Energy outlines the significant barriers that currently exists to bringing competition to the mass market. Direct Energy has encouraged the Department to take bold steps to address these barriers and create a robust market for residential and small business customers -- an approach which includes a retail auction. As Massachusetts continues to work towards a competitive market in the residential sector, the Department also must continue to ensure that regulatory policy does not interfere with the continuation and growth of the competitive market in the commercial and industrial sectors. It is Direct Energy's view that a policy which allows LDCs to provide risk management products and services hinders the Department's ability to meet that objective.

LDCs' use of financial risk-management tools also negatively affects gas unbundling and customer choice because it affects the reliability and transparency of the rates charged by LDCs. As NSTAR described the problem in *Risk-Management*:

> One of the building blocks in the development of a competitive retail market for natural gas is the need to provide transparent price information to the emerging marketplace in relation to the prices charged to gas customers of the LDC. Thus, it is important for LDCs to continue purchasing gas at published market prices so that competitive marketers are able to anticipate what the LDC's cost of gas will be at any given time. Maintaining a price that reflects current market conditions provides competitive suppliers with the opportunity to achieve cost savings for customers, without the entire LDC customer base taking on additional cost and risk associated with the use of hedging instruments.

NSTAR Comments, *Risk-Management* at 8-9.

Direct Energy supports the Attorney General's suggestion that LDCs only should be allowed to offer products and services designed to smooth out price movements, through an unregulated affiliate that provides the service as a competitive offering that is separate and distinct from the existing GCAC recovered gas supply service provided by the regulated utility company. *See* Attorney General Comments, *Risk-Management*, at 9 n.5.

In addition to discouraging competition, LDC risk-management programs provide no cost relief for customers. It is undisputed that risk-management techniques by the LDCs do not necessarily result in lower prices for customers. As the Department has concluded: "due to the volatile and unpredictable nature of commodity derivatives markets . . . financial risk-management programs *are unlikely to produce prices below index levels averaged over time*, though they may dampen volatility." *Risk-Management* at 6 (emphasis added). Stated simply, customers are unlikely to save any money and indeed, may be paying more than the market price for gas when LDCs use risk-management tools. Because the competitive market can address concerns associated with price volatility, there is no net benefit, and indeed there is risk, for consumers in having the LDC implement risk-management techniques.

The rationale given for allowing the possibility of higher gas prices through LDC-implemented risk-management programs is to mitigate price volatility and establish rate continuity. *See Risk-Management* at 5. Advocates of such programs state that they are designed to prevent "sticker shock" during the winter months when the price of gas is at its highest. As stated above, however, if customers desire fixed prices or more stable prices, such products can and should be offered in the competitive market. Moreover, allowing the competitive market to offer these types of products does not leave the LDCs without tools for addressing variations in customers' bills from month to month. NSTAR, for example, offers its customers levelized or budget billing plans that help mitigate the impact of volatility for customers while still meeting the LDC's least-cost purchasing standard. NSTAR Comments, *Risk-Management* at 2.

In conclusion, Direct Energy encourages the Department to gather further information from NSTAR regarding its proposal. Among other matters, NSTAR should provide information regarding its potential use of derivative products, the costs associated therewith and its plans for cost recovery before approving its proposed plan. However, even if the Department concludes that NSTAR's proposal will not involve any derivative products or implementation costs, Direct Energy respectfully requests that the Department re-examine its overall approach to risk-management and allow the competitive marketplace, not the LDCs, to sell products and services designed to mitigate volatility.

Very truly yours,

John A. DeTore

cc : Cheryl Kimball, Esq.
Jody Stiefel, Hearing Officer